APPENDIX.

Section 23 of the Revenue Act of 1936:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions: * * *

(1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

Regulations 94 under the Revenue Act of 1936:

Article 23(1)-1. Depreciation. A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. * * *

Article 23(1)-2. Depreciable property. The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. * * *

Article 23(1)-6. Obsolescence. With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made. No deduction for obsolescence will be permitted merely because, in the opinion of a taxpayer, the property may become obsolete at some later date. This allowance will be confined to such portion of the property on which obsolescence is definitely shown to be sustained and cannot be held applicable to an entire property unless all portions thereof are affected by the conditions to which obsolescence is found to be due.

Rulings of the Commissioner of Internal Revenue:

O. D. 381, 2 C. B. 138 (1920).

No amount may be charged off in any year in anticipation of obsolescence of a building which may become obsolete five or ten years later. However, a certain amount of obsolescence may be claimed from the time that it becomes certain that at a definite future date the building will be obsolete. The figure representing obsolescence should be, approximately, the difference between the fair market value of the building as of March 1, 1913 or its cost if acquired after that date, less depreciation, and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building becomes obsolete and should be claimed in the returns filed for those years. For instance, the fair market value of a building March 1, 1913, was $30,000. Its depreciated value December 31, 1918 was represented by $18,000. and its estimated salvage value will be $5,000. in 1920. At that time (December 31, 1918) it was definitely determined and certain that in 1920

the building would have to be torn down and rebuilt, due to its inadequacy to meet the growing needs of the industry it housed. The difference between the depreciated value December 31, 1918, namely, $18,000. and its estimated salvage value of $5,000. represents obsolescence. This amount of $13,000. should be spread over the years covering the period 1919 and 1920, and deductions claimed accordingly on the returns filed for those years. In cases where obsolescence is claimed it must be supported by facts which will enable this office to determine whether such claim is proper and allowable.

I. T. 1775, II-2 C.B. 145 (1923).

In 1921, the taxpayer purchased the abstract plant of the M Company. At the time this plant was purchased it was thought it could be used to advantage in the abstract and title guaranty work of the taxpayer but was found upon trial to be inefficient and the records in part a duplication of the records of the taxpayer. It was then decided not to continue additions thereto from day to day in order to keep it up-to-date.

Advice is requested as to whether the taxpayer may take as a deduction depreciation sustained to the plant in view of the fact that it has not been added to or kept up-to-date since its purchase.

Held, that it is a proper case for depreciation or obsolescence allowances and the cost of the plant less the salvage value thereof should be spread equally over the period from the date the permanent abandonment of the plant was foreseen to the date of the permanent abandonment and deductions allowed each year in such amounts for income tax purposes.